Harmonizing the GST and Fixing the Fiscal Imbalance: Comment on Smart and Bird[*]

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Michael Smart and Richard Bird's proposal offers a multi-component package:

- the federal government cuts the GST by 2 percentage points;
- the feds simultaneously cut their transfers to the provinces by their lost GST revenues;
- the provinces recoup their lost federal transfers by raising their sales tax rates; and
- retail-sales-tax provinces convert to a value-added format harmonized with the GST.

This policy package sounds eminently desirable—yielding the holy grail for Canadian public finance by fixing the fiscal imbalance while also perfecting the indirect tax system.

However, the Smart-Bird proposal also strikes me as highly optimistic unless it is further elaborated to give the policies effective bite, and even then its adoption is far from assured. While the proposal is technically feasible, its underlying political economy raises some basic issues requiring careful treatment.

Let me begin with the proposal's fiscal imbalance aspects. Since the feds would reduce their provincial transfers by the full amount of their revenue loss from cutting the GST rate, this policy entails zero revenue cost for the federal fisc. That's fine for the feds, but what attraction does it hold for any of the provinces? At best a province can break even fiscally but only if it raises its own taxes to fill the vacated federal tax room. I note that the proposal includes adjustments to various fiscal transfer programs to avoid cross-provincial impacts. One advantage from this arrangement for the provinces is that their future revenues would have assured growth in contrast to the perennial uncertainty over levels of federal transfers. Nevertheless, this type of transfer reform is not likely to be a barn-burner in any of the provincial capitals.

I'd also like to dispense quickly with one of the proposal's strong claims about the merits of such a remedy to fiscal imbalance. The authors envisage a major improvement in the fiscal accountability of provinces that have to raise more of their own revenues and rely less on federal transfers. In particular, they assert that this will help to contain public health care spending through cost-saving innovations. This point might be valid if the feds were to discontinue, in a credible manner, *all* transfers to the provinces other than

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[*] Michael Smart and Richard Bird, "The GST Cut and Fiscal Imbalance," Department of Economics, University of Toronto, draft, June 27, 2006.
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equalization. But even with the $10 billion annual cut suggested in this proposal, the feds would remain a significant backer of provincial finances. At the margin, the provinces would continue to look to the feds for help in covering future growth in their health care costs. Remember the transfer of tax points from the feds to the provinces many years ago? The provinces don't seem to remember them, or to count them, in any of the ongoing debates about fiscal imbalance.

In a brief aside, I'd like to ask whether a harmonized sales tax, even one in which each province could set its own tax rate independently, would in fact be a more fiscally accountable system. Consumers would face a single combined tax rate at the cash register—such as the 14 percent rate now in the HST provinces—with no indication of how much is federal tax and how much provincial tax. They undoubtedly would notice when a province raised or lowered its portion of the combined rate, but over time they would come to see it as a single tax going in unattributed proportions to "government." With the current system, the federal GST and provincial RST are separately identified.

Now I'd like to turn to the sales tax reform portion of the proposal. Getting the provinces to harmonize their sales taxes with that of the federal GST has been a devout goal of analysts at Finance Canada ever since the tax's inception in 1991—indeed ever since the 1987 White Paper on Sales Tax Reform. Other than the HST of three Atlantic provinces, bought with $1 billion of federal compensation, and Quebec's own route to a value-added tax, this has been an elusive dream of policymakers and economists alike. While the Smart-Bird proposal would press the provinces to find additional own-source revenue, and open room in the sales tax domain by virtue of a reduced GST rate, it offers no effective leverage for the non-harmonized provinces to enact reforms along value-added tax lines. The hazard is that the provinces would simply crank up their rates on income taxes and on deficient retail sales taxes.

In essence, the Achilles' heel of sales tax reform is the large visible shift of indirect tax burdens from the business sector to the household sector. Smart and Bird provide very useful estimates of this shift for each of the non-harmonized provinces. My table presents their findings, supplemented with some calculations based on retail sales tax revenues for those provinces. Shifting provincial RSTs to a GST format at roughly revenue-neutral rates shows that about 30 to 40 percent of current RST revenues would be lifted from the business sector, varying by province (businesses actually pay an even higher proportion of all RST currently, because the GST would not remove all taxes from the exempt business and MASH sectors). Stated differently, to collect the same level of total revenues when shifting from the RST to a GST would require raising the visible provincial sales tax burden on consumers by an average of 45 percent. The aggregate jump in consumers' sales tax burdens in the five provinces would have been $6.2 billion in 2002 and would exceed $7.5 billion by 2007.

Clearly, that large shift in visible taxes (away from business and onto voting consumers) is the biggest obstacle to getting provinces onto the sales tax harmonization wagon. No doubt, they might like to please the business community by simplifying the country's overall indirect tax system. And as shown in previous research by both Richard Bird and Charles McLure, the provinces could retain considerable discretion over both the base and the rate of harmonized provincial VATs by following the Quebec Sales Tax model.

Moreover, as economists argue, consumers are already bearing most of the costs of those RSTs applied to business capital and intermediate inputs through higher market prices on goods and services, although some of those taxes likely get shifted out of province or abroad depending on competitive conditions in the relevant markets.

Yet none of those facts will blunt the public's strong resistance to such a move or politicians' sensitivity to the issue. Additionally, voters are expecting the second installment of the government's pledged GST cut to go into their own pockets, not to lubricate the process of some abstract tax reform. Smart and Bird acknowledge the need for federal "transitional assistance" to facilitate provincial sales tax harmonization, but we require concrete proposals that will meet various economic *and* political tests. What tangible sweeteners can the feds provide to the provinces? One constraint on federal actions is that it cannot blatantly benefit the non-harmonized provinces over those that already have VAT-type sales taxes or the province without a sales tax.

One important step in solving this problem would be to use the Quebec Sales Tax as a model for harmonization. In earlier years the QST did not allow businesses to claim full input credits for some purchases, and even today larger companies cannot claim credits for certain types of purchases. This approach reduces the shift of tax burden onto consumers, thus rendering harmonization more politically palatable. The Canada Revenue Agency could enter into tax collection agreements with individual harmonizing provinces if they agreed to provide at least 70 percent input tax credits for business capital purchases, rising to 100 percent over a specified number of years, and at least 50 percent input tax credits for intermediate input purchases. Thus, greater weight would be placed on reducing the tax burden on capital than other business costs. Note in my table that for the non-harmonized provinces, the sales tax impact on business capital accounts for just 8 percent of RST revenues, or just one-quarter of the RST's total business impact.

Additionally, the feds could rebate to harmonizing provinces the incremental federal business income taxes arising from the reduced business deductions for sales tax incurred on their inputs. Quebec would receive rebates to the extent that it raised the rate of QST business input credits. The federal rebate should be about 20 percent of the provincial loss of sales tax on businesses, and the provinces should recoup another 10 percent or more in their own income taxes. The rebate provision might be open for a limited period to encourage early action by the provinces, and it would not display any provincial favouritism. Of course, as competitive product prices declined following tax harmonization, the business income tax impacts would also diminish.

Another area that might require attention for wider sales tax harmonization is the treatment of new housing units. Currently the on-site labour content of new construction is omitted from RSTs, while the GST base includes both that and land value. With new detached homes selling for $700,000 or more in Vancouver and Toronto, this would pose a big problem. A harmonized combined federal-provincial tax rate of about 14 percent in Ontario and 13 percent in BC (plus BC's 2 percent property transfer tax) would imply nearly $100,000 in taxes for a $700,000 home—a hard sell politically. Moreover, the current GST treatment of new housing departs from basic value-added tax principles. Only newly produced goods and services should be subject to tax, not the land component, which was neither newly produced nor value-added. Assessing the GST

based on total construction cost, but excluding land value, would remedy this problem, albeit with some complication to the valuation process. The resulting relief would accrue to all provinces, but its benefits for the two largest non-harmonized provinces, Ontario and BC, would be proportionately greatest on account of their high urban land values.

One area where the harmonizing provinces might wish to depart from the current GST taxable base is services provided directly to homeowners, such as home repair, maintenance, and renovation. The inclusion of these services under the GST was likely one reason for the measured increase in tax evasion with the introduction of that tax; it also likely led to decreased revenues through parallel income tax evasion. Some provinces may wish to continue current exemptions of their RSTs, such as books and meals in BC. We should bear in mind that with the Smart-Bird proposal, the provincial portion of the total harmonized tax would be much larger than the federal portion. The federal rate would drop to 4 percent, and the provincial rate would rise to 9 percent in BC and 10 percent in Ontario. This would put greater scrutiny on each province's decisions about what consumer goods and services to include or exclude in the provincial part of the tax, so that these policies would become more politicized at the provincial level.

To make sales tax reform feasible, we need to devise a set of economically acceptable and politically appealing provisions to address the problem of large visible shifts in tax burdens onto consumer-voters. I've noted several that might do the job:

- a Quebec format of tax that would allow provinces to credit only part of sales tax on business intermediate inputs and a phased move to 100 percent credits on capital inputs;
- a federal rebate to harmonizing provinces of the incremental federal business income tax revenues arising from sales tax reform, at least over a transitional period;
- leaving each province the option of exempting (or rebating tax on) certain politically problematic goods and services, thus departing from the federal GST base; and
- charging GST and provincial VAT for the cost of new housing units excluding the land value, which would be consonant with VAT principles and most appealing to residents in the key provinces for successful of the harmonization exercise, Ontario and BC.

Others may not agree with all of my specific suggestions and are welcome to bring other ideas to the table; with sufficient flexibility, the odds of a policy breakthrough improve.

Let me briefly illustrate how such a reform could be packaged. For reasons cited earlier, I would dispense with any big attempt to fix the fiscal imbalance as part of sales tax reform. We could contemplate the feds cutting the GST rate by another 1 percent two or three years ahead of their announced 2011 target. There would be no companion reductions in federal transfers to the provinces, and the provinces would recoup part of the federal cut by raising their sales tax rates by one-half percentage point. Consumers would see a one-half percent cut in their combined federal-provincial sales tax rate, less than they had been promised but arising a couple of years early. By 2008 or 2009, that GST cut would be worth nearly $6 billion, and the non-harmonized provinces would recoup more than $2.5 billion in revenues by hiking their tax rates. That sum along with the previously suggested provisions would allow those provinces to harmonize sales taxes while greatly moderating the visible tax shift onto consumers.

We need to be realistic about the uncertain prospects of the harmonization exercise, even with well-designed enhancements. The challenge may simply prove to be too difficult or not worth any government's political capital relative to competing priorities. Other fiscal policies could substitute for sales tax harmonization, albeit quite imperfectly and without the administrative and compliance cost savings. For example, the RSTs' biggest economic deficiency is its burden on business capital, accounting for a large part of Canada's high marginal effective tax rate on investment; Smart-Bird offer credible empirical findings that sales tax harmonization in the Atlantic provinces raised their investment. As a second-best policy approach, this matter could be addressed in the business income tax system by instituting an investment tax credit or accelerated depreciation. For several years after 2000 the United States provided a 50 percent first-year "bonus" depreciation allowance for businesses that had a similar purpose.

Finally, we should not neglect the role of Canada's largest revenue source, the personal income tax. Smart and Bird open their study by stating: "No tax is perfect; but as taxes go the GST is … about as good as they get. … [I]f any rates are to be cut it should be income tax rates." I will respectfully disagree. Our so-called "income" tax is in fact much closer to a tax on consumption than income for most Canadians, on account of tax-deferred pension plans and RRSPs and tax-free gains on homes. Its key departures from a consumption base arise for those at the lowest and the highest incomes. As I have argued elsewhere, those deficiencies could best be remedied by introducing tax-prepaid savings plans, such as the Registered Lifetime Savings Plan of the Conservatives' pre-election platform. And unlike the GST, income taxes allow for rate progressivity and the differing circumstances of individual taxpayers. So before urgently cutting the rates of direct personal tax, our policies should aim to enhance its consumption base. That's very much like what we should be doing with indirect taxation by reforming our provincial sales taxes so that they, too, become truer consumption taxes.

Revenue Impacts of Shifting Provincial RSTs to VATs, Using Historic Statutory Tax Rates, 2002, $millions

	PEI	**ON**	**MB**	**SK**	**BC**	**Totals**
Consumers						
Goods	28	1,252	67	200	353	1,900
Services	11	754	70	115	722	1,672
Housing	16	1,816	73	52	549	2,506
Total consumers impact	**55**	**3,822**	**210**	**367**	**1,624**	**6,078**
Business						
Construction inputs	-25	-1,553	-116	-130	-519	-2,343
Other intermediate	-16	-1,516	-106	-119	-516	-2,273
Capital	-12	-1,021	-125	-79	-351	-1,588
Total business impact	**-53**	**-4,090**	**-347**	**-328**	**-1,386**	**-6,204**
Government impact	-4	147	-14	-24	-15	90
Total revenue impact	-1	-121	-151	16	224	-33
RST revenues 2002/03	**166**	**14,061**	**1,022**	**835**	**3,581**	**19,665**
Total business impact/ revenues (%)	31.9	29.1	34.0	39.3	38.7	**31.5**
Business capital impact/ revenues (%)	7.2	7.3	12.2	9.5	9.8	**8.1**
Consumers impact/ (revenues – total business impact) (%)	48.7	38.3	31.1	72.4	74.0	**45.2**

Sources: All figures through “Total revenue impact”: Michael Smart and Richard Bird, “The GST Cut and Fiscal Imbalance,” draft, University of Toronto, June 27, 2006; RST revenues: Canadian Tax Foundation, *Finances of the Nation 2003* (Toronto: 2004), 5:7; last three rows are my computations (note that the last row is a very rough measure of the requisite rise in consumer burdens).